Financial Markets

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Irving Trust

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Economic Research &
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Friday
(Noon)

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The bond market has continued its good performance since the Treasury's auctions. Indeed, market sentiment has shifted abruptly to greater optimism--perhaps toward too much optimism. While it's hard to fault the bond market's recovery, the recent lowering of short-term rates seems much less durable. Money market certificates such as CDs have reduced their yield by about 25 basis points to 9 3/4%; Eurodollars have done even better. Attention has focused on a few days of the Fed funds rate falling below the lower limit of its recent trading range. Talk has begun to shift to the notion that the peak in rates is behind us, but is it?

I don't think so, at least not for money market rates. As for long rates, they will probably back up again, well before year-end, but bonds may not pierce the low price levels reached at the last auction. These determinations are based on a view of the Fed's likely reaction to recent events and my perception that the short end of the market has falsely followed the improvement in long rates. So what is the Fed's next move?

Almost certainly the next move will be to firmer rates. The market's recent infatuation with slow money supply growth misses the most crucial point: the economy. Having money supply (M1) within "target" is neither a necessary nor a sufficient condition for lower interest rates. Conversely, a weakening economy is both necessary and sufficient to prompt the Fed to lower rates. The latter point is quite clear; the point about money supply may not be. To understand it, realize that the Fed would be very worried about further excessive money growth because of the high level of the current M1 monitoring zone. Also realize that lower growth, within the new monitoring zone, would be well above the upper limit that the Fed previously had intended for M1 by this time in the year. The Fed had said that the performance of M1's velocity would determine where the Fed would like M1 to be within the (original, broad) 4%-8% target range it had set. Thus the role played by the economy should be easier to see: If the economy remains strong and if money supply growth slows, that means velocity will be rising. An indication of rising velocity would surely put the Fed on the defensive, even if M1 is within its new monitoring zone.

All this analysis is very pessimistic stuff for a market as bullish as the one we have been in. But the market is behaving as markets do: wary of the longer-term factors and trading the short-term trends. For now, M1 has given the market heart: a better-than-expected number last Friday (Aug. 12), prospects of small declines this week and next week--but for the last two weeks in August a cumulative increase of $6 billion. These increases are too distant in time to trade on now. Near term, the market seems insulated from a dramatic money supply shock. As a result, we may have as much as a week or two of good performance in the bond market, perhaps less in the money market, before reality sets in.

Robert A. Brusca

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Market Yields

	8/19/83 (Noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	11.00%	11.00%	14.00%
Effective since	8/8/83		
Discount Rate at Federal Reserve Bank	8.50	8.50	10.50
Federal Funds	9.50	9.63	8.63
Repurchase Agreements	9.25	9.50	7.25
U.S. Treasury Issues			
Bills			
3 months	9.65	9.85	6.87
6 months	10.02	10.27	8.74
1 year	10.33	10.68	9.84
Coupons			
2 years	10.84	11.24	11.08
4 years	11.30	11.69	12.05
7 years	11.58	11.91	12.30
10 years	11.69	12.01	12.26
Long Bond	11.69	11.97	12.16
Negotiable Certificates of Deposit-Secondary Market			
1 month	9.55	9.70	9.20
3 months	9.70	10.00	9.55
6 months	10.00	10.40	10.50
1 year	10.55	11.00	11.00
Banker's Acceptances			
1 month	9.60	9.68	9.00
3 months	9.77	10.05	9.50
6 months	10.10	10.51	10.40
Eurodollar Deposits			
1 month	9.88	9.88	9.88
2 months	10.00	10.25	10.00
3 months	10.19	10.44	10.25
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	9.27	9.53	6.09
1 month	9.59	9.84	8.17
3 months	9.87	10.13	8.81
Bank Holding Companies			
1 month	9.33	9.45	7.91
Dealer Placed:			
3 months	9.84	10.15	8.81
New AA Corporate Utility Bond	12.88	13.30	14.13
Tax Exempt			
6 month Project Notes	5.65	5.65	5.00
1 year AAA Bond	5.50	5.70	6.75
5 year AAA Bond	7.20	7.10	8.50
20 year AAA Bond	9.30	9.50	10.00

This information represents prevailing market yields.

It should not be construed as an offering.

All yields are on the offered side of the market.

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